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SIPDIS

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SUBJECT: EGYPTIAN GAS PRODUCTION EXPANDING

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Summary

¶1. (SBU) Egypt's ambition to become a major player in the gas sector is starting to be realized. With upstream and downstream production levels increasing and progressive policy makers thinking decades ahead, Egypt is on track to become a global gas producer, provided it sustains its exploration and production pace. The need for hard currency and the steady decrease in Egyptian crude oil exports drove rapid liquid natural gas (LNG) development over the last few years. Egypt began exporting LNG in early 2005 with a new "LNG highway" between Egypt and Spain. The first shipment of 136,000 cubic meters of LNG departed from the Egyptian plant at Damietta in January, headed for the Spanish re-gasification terminal at Palos de la Frontera in Huelva. Additional shipments are already in the pipeline for the next few years. The British Gas (BG) Group will soon be Egypt's largest LNG buyer with the opening of a second LNG facility in Idku. The success of the Damietta and Idku LNG projects give incentive to Egyptian and multinational companies to expand gas exploration efforts, especially into the potentially large gas reserves in the Mediterranean. Some exports of Egyptian LNG will go to the U.S., but the majority will go to Mediterranean countries, namely Spain, Italy, and France. Foreign exports will remain high in the short-term, but may decrease in the long term as oil reserves shrink and domestic energy demand increases. End summary.

Gas in Egypt

¶2. (U) As of December 2004, proven (discovered and confirmed) gas reserves amounted to about 66 trillion cubic feet (TCF) with an additional 100 TCF of probable/undiscovered gas reserves, ranking Egypt 25th world wide and 8th among Arab countries in terms of proven reserves. Most gas discoveries made in the 1990s were located just off the Nile Delta in the Mediterranean and in the northern part of the Western Desert. A few smaller fields were also found in the Gulf of Suez oil concessions.

¶3. (U) The government hopes that these impressive gas reserves will compensate for declining oil reserves and provide much needed foreign currency. Crude oil production has been falling for a decade, from a high of more than 920,000 barrels per day (bpd) in 1995, to an average of slightly less than 600,000 bpd in 2004. Proven crude oil reserves declined from about 4 billion barrels in the early 1980's to less than 3 billion in 2001, but have stabilized this year due to recent small discoveries. Meanwhile, domestic consumption grew steadily through the 1990's to reach 460,000 bpd in 2001, squeezing Egypt's exports of oil and petroleum products. Domestic consumption has remained steady over the last three years at about 475,000 bpd as Egypt's economy slowed, but as the economy grows (present rate of growth is between 4-5%), consumption levels will rise again, with a probable simultaneous fall in oil exports.

¶4. (U) In contrast to oil, production of natural gas is expanding rapidly. Over the last five years, natural gas production has increased by approximately 75%, reaching about 3.3 billion cubic feet per day (bcf/d). Production is expected to rise to around 5.0 bcf/d by 2007, with a significant portion of the production exported as LNG. The majority of the gas produced presently is consumed in the increasingly demanding domestic market, with 62% going to Egypt's thermal power plants to meet the country's growing demand for electricity. About 500 industrial factories, 55,000 CNG vehicles, 13,000 commercial customers, and more than 2 million residents consume the remaining 38%.

¶5. (U) Since the 1980,s, the GOE has mandated that foreign exploration for oil and gas must be carried out under a legally binding contract called a Production Sharing Agreement (PSA) between the foreign oil company and the state owned Egyptian General Petroleum Corporation (EGPC).

According to the PSA, the foreign company covers the total cost of any exploration activities (i.e., is solely responsible for the exploration risks). For example, if the exploration wells in a specified concession under a PSA are dry or the discovery is not advantageous, then EGPC does not share the losses and the foreign company simply stops exploration. However, if oil/gas is discovered, then EGPC and the foreign oil company form a joint venture company which then initiates production. The foreign partner would recover its investment by receiving an agreed upon percentage of the profit from selling the oil or gas abroad or to the GOE.

¶6. (U) The GOE formed an entity similar to EGPC, called the Egyptian Natural Gas Holding Company (EGAS) in August 2001 to focus on gas. EGAS objectives are to (a) manage the sales of gas transmission and distribution systems and coordinate all related activities including the management of the more than 3,000 kilometers (km) of national gas pipelines; (b) develop gas projects with national and international partners, and (c) participate in exploration, development, and production from gas discoveries.

¶7. (U) The major players in gas exploration and production in Egypt are BG, British Petroleum (BP), ENI-Agip, Apache, and Shell. A total of four gas export projects are currently planned or active; the Damietta LNG facility and the pipeline to Jordan are in operation, the Idku LNG facility has had a soft opening, and construction on the Israeli pipeline is expected to begin this October.

Gas Pipeline - Jordan

¶8. (U) Egypt started its first gas export operations by piping gas to Jordan in late July 2003. The project began in early 2001 with the construction of a 264 km pipeline from existing pipeline terminals at El-Arish in northern Sinai, to Taba at the tip of the Gulf of Aqaba, and finally across the border to the Jordanian port of Aqaba. During the first year, gas exports to Jordan generated gross revenues of approximately USD 70 million. Revenues from this facility are expected to increase to USD 200 million by the end of ¶2005.

¶9. (U) The second phase of the project, at an estimated cost of USD 300 million, entails construction of a 370 km of pipeline to transport the natural gas delivered at Aqaba to the Samra and Rehab power stations in northern Jordan. The pipeline was laid down by an Egyptian-Jordanian joint venture company and is part of a broader plan to distribute Egyptian natural gas to the region, including to the Zahrani refinery in northern Lebanon and to the Syrian port of Banias and possibly on to Cyprus.

Gas Pipeline - Israel

¶10. (SBU) On June 30, Israeli Infrastructure Minister Binyamin Ben Eliezer and Egyptian Oil Minister Sameh Fahmi publicly signed a memorandum of understanding for Egyptian gas sales to Israel. The GOE encouraged the formation in 2000 of the Egyptian Eastern Mediterranean Gas joint venture company, owned by Israeli businessman Yossi Mieman's Merhav Group (25%), Egyptian businessman Hussein Salem (65%), and the GOE's Egyptian Gas Holding Company (10%), to negotiate the deal with the Israel Electric Corporation. The parties concluded an agreement in principle in early summer 2004 and concluded a framework agreement in February 2005. The agreement signed was a political understanding between the two governments; the signing in Cairo, witnessed by Egyptian Prime Minister Nazif, was the most high-profile public recognition of the deal to date. A commercial agreement laying out the precise terms of the operation remains pending.

¶11. (SBU) According to the agreement, an offshore pipeline will be constructed from El Arish in Sinai up to the coast of Israel, bypassing Gaza. Construction could begin as early as October 2005 with Egyptian gas possibly flowing to Israel by the second half of 2006. Under the agreement, Egypt would provide approximately 1.7 billion cubic meters of gas per year for 15 years for a total amount of USD 2.5 billion, making this Egypt's most lucrative gas deal ever.

LNG - Damietta

¶12. (U) The first LNG facility in Egypt is located in Damietta, on the Mediterranean shore. It is owned and operated by the Spanish Egyptian Gas Company (SEGAS), a special purpose operating company 80% owned by Union Fenosa Gas (50% Union Fenosa of Spain and 50% ENI of Italy), 10% by EGAS, and 10% by EGPC. The $1.3 billion LNG facility awarded the engineering, procurement, and construction contract for

the project to the joint venture of Halliburton KBR, JGC Corporation of Japan, and Tecnicas Reunidas (TR) of Spain. The LNG facility is located in the duty free zone of the recently modernized Damietta port. The SEGAS facility was completed record time for a grassroots LNG facility - less than 4 1/2 years from signing the project in August 2000 to "Ready For Start Up" in November 2004, almost two years faster than the previous industry benchmark.

¶13. (U) The production capacity of this facility, 5.5 m tons/yr, has already been committed for the next 25 years. Union Fenosa, as the principle, guarantees to purchase 3.2 m tons/yr of the facility's overall 5.5 m tons/yr capacity. In addition, EGAS signed an agreement with SEGAS in June 2003 whereby EGAS will guarantee to provide/sell the remaining 2.3 m tons/yr of spare capacity to other international buyers.

¶14. (U) The BG Group will soon be Egypt's largest LNG buyer. Among the first of BG's transactions with SEGAS was a 60,000 ton LNG shipment that was originally headed to the U.S., but changed direction midstream and went to Europe. In addition, BP, EGPC and EGAS negotiated an agreement to provide up to 310 m tcf/day to the plant starting in 2008. BP may also be in the final phase of negotiations with SEGAS to use the LNG facility to export gas to the U.S. market.

¶15. (U) The Damietta LNG facility is currently the largest single LNG train facility ever built, with a capacity of approximately 5.5 m tons/yr. The export capacity of the Damietta project moves Egypt to the rank of thirteenth among nations in terms of LNG exports. Moreover, SEGAS may be considering plans for a second train of 5.5 m tons/yr capacity at the Damietta complex, after securing a joint off-take and feed-stock agreement for Train 1 with Union Fenosa. The decision to construct another train will not be finalized before mid-2005. However, SEGAS is already raising investment capital for the second train.

LNG) Idku

¶16. (U) The second LNG project, located in the Idku area 50 km east of Alexandria, is controlled by the Egyptian Liquefied Natural Gas Company (ELNG) consortium. Bechtel and Halliburton are constructing the two LNG trains at Idku for about USD 2 billion. Beheira Natural Gas Liquefaction Company owns the first train (Train 1), which will have a capacity of 3.6 million t/yr. The main shareholders of Train 1 are BG (35.5%), Malaysian PetroNAS (35.5%), Gaz de France (GdF 5%), and the GOE (24%). This first train expects to begin exports by the last quarter of 2005. GdF bought the entire gas output of Train 1 for 20 years starting from 2002.

¶17. (U) Idku Natural Gas Liquefaction Company owns the second natural gas liquefaction train (Train 2) which will have a capacity of 3.6 million t/yr. The main shareholders of Train 2 are BG (38%), Malaysian PetroNAS (38%), and the GOE (24%). Train 2 expects to begin exports by the end of 2005 or early 2006. A sale and purchase agreement was signed on 24 September 2003 for BG to export the entire production from Train 2 to the U.S. and Italy. The BG-operated Simian/Sienna gas fields will supply feed-stock for the project. By the beginning of 2008 BG will buy 3.2 bcm/year from Idku for sale to the Italian electricity company ENEL with delivery at the Brindisi LNG terminal in southern Italy. This supply will initially be sourced from Train 2. Until Brindisi LNG is operational the production from Train 2 will be supplied primarily to the Lake Charles LNG importation terminal in Louisiana.

Future of Gas in Egypt: Analysis and Conclusion

¶18. (SBU) The GOE is eager to bring these projects online quickly because Egypt needs (a) hard currency in order to compensate for the losses from declining exports of crude oil; (b) to create employment; and (c) to convince multinationals to keep investing in Egypt's emerging gas industry.

¶19. (SBU) Some Egyptian gas experts argue investors should export as much gas as possible now because Egypt's domestic gas demand is expected to rise rapidly, dampening exports. The GOE recently announced a policy that calls for a balance between medium term export commitments, local needs, and long term strategic requirements. The GOE believes it can strike this balance if it keeps export commitments below one-third of proven gas reserves at any time.

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